

Discover Financial Services (DFS)

Rating **OUTPERFORM**
Price (14-Mar-17, US\$) 71.80
Target price (US\$) 82.00
52-week price range (US\$) 73.94 - 48.84
Market cap (US\$ m) 27,681.35

Target price is for 12 months.

Research Analysts

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COMMENT

Acceleration in Loan, NCO and Delinq Growth

- **Card growth acceleration:** EOP card loans grew 7.5% y/y in February (40 bps acceleration) to \$59.9Bn (-1% m/m), faster than our forecasted 7% loan growth in 1Q17.
- **Increase 1Q loss estimate:** Net charge offs were \$155MM (+18% m/m, +38% y/y). Y/Y growth accelerated by 18 pps. The net loss rate was 3.10% (+50 bps m/m, +70 bps y/y). We took up our card loss rates in 1Q and 2Q to 2.78% (+13 bps) and 2.85% (+20 bps), respectively. We maintained our reserve build of \$270MM for FY2017 and \$228MM for FY2018, respectively.
- **Delinquency growth acceleration:** February had \$1.258Bn in dollar delinquencies (-1% m/m), growing 33% y/y (8 pps acceleration). The delinquency rate was 2.1% (flat m/m, +40 bps y/y).
- **1Q EPS est lower than cons, maintain FY EPS:** Our 1Q EPS (\$1.44) is 2c lower than consensus as we believe the acceleration in NCO and delinq growth will result in higher provision. Discover is currently trading at 10.5x consensus' 2018 EPS and our \$82 target price represents 12.1x our 2018 estimate.

Share price performance



On 14-Mar-2017 the S&P 500 INDEX closed at 2365.45
Daily Mar15, 2016 - Mar14, 2017, 03/15/16 = US\$48.71

Quarterly EPS	Q1	Q2	Q3	Q4
2016A	1.35	1.47	1.55	1.40
2017E	1.44	1.48	1.63	1.56
2018E	1.73	1.74	1.66	1.67

Financial and valuation metrics

Year	12/15A	12/16A	12/17E	12/18E
EPS (CS adj.) (US\$)	5.13	5.77	6.10	6.80
Prev. EPS (US\$)	-	-	-	-
P/E (x)	14.0	12.4	11.8	10.6
Relative P/E (%)	-	62	65	65
Revenue (US\$ m)	8,739.0	9,099.0	9,782.4	10,306.6
Pre provision Income (US\$ m)	5,124	5,515	6,008	6,313
Book Value (US\$)	25.39	27.67	29.09	31.25
Tangible book value (US\$)	24.39	26.59	27.94	30.03
ROE (%)	20.9	21.8	21.6	22.7
ROA (%)	2.64	2.61	2.41	2.38
Book Value (Next Qtr., US\$)	27.92		Tangible BV (Next Qtr) (US\$)	26.82
P/BV (x) (Next Qtr.)	2.6		P/TBV (Next Qtr) (x)	2.7
Dividend (Next Qtr) (US\$)	1.20		Shares Outstanding (m)	386
Dividend yield (%)	1.6			

Source: Company data, Thomson Reuters, Credit Suisse estimates

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Figure 1: Discover Monthly Credit Card Charge-off and Delinquency Statistics

In \$Bn unless otherwise stated

	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Change		
														M/M	Y/Y	
Credit Card																
Ending Loans	55.7	55.6	55.9	56.8	57.2	57.5	58.2	58.0	58.5	59.8	61.5	60.7	59.9	-1.3%	7.5%	
Y/Y Growth	4.3%	3.9%	3.7%	4.2%	4.2%	4.2%	3.9%	4.1%	5.6%	5.8%	6.2%	7.1%	7.5%			
Average Loans	56.0	55.3	55.6	56.0	56.7	57.1	57.6	58.0	58.0	58.6	60.7	60.9	60.0	-1.5%	7.1%	
Y/Y Growth	3.9%	4.3%	3.7%	3.9%	4.0%	4.2%	3.8%	4.3%	4.9%	5.4%	6.1%	6.7%	7.1%			
Net Principal Charge-off Rate (1)	2.40%	2.20%	2.50%	2.40%	2.30%	2.20%	2.10%	2.20%	2.40%	2.50%	2.50%	2.60%	3.10%	50 bps	70 bps	
30+ Delinquency Rate (2)	1.7%	1.7%	1.6%	1.6%	1.6%	1.7%	1.8%	1.9%	2.0%	2.0%	2.0%	2.1%	2.1%	0 bps	40 bps	
Net Principal Charge-off Dollars (\$MM)	112.0	101.4	115.8	112.0	108.7	104.7	100.8	106.3	116.0	122.1	126.5	132.0	155.0	17.5%	38.4%	
30+ Delinquency (\$MM)	947	945	894	909	915	978	1,048	1,102	1,170	1,196	1,230	1,275	1,258	-1.3%	32.8%	

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 14-Mar-2017)

Discover Financial Services (DFS.N, \$71.8, OUTPERFORM, TP \$82.0)

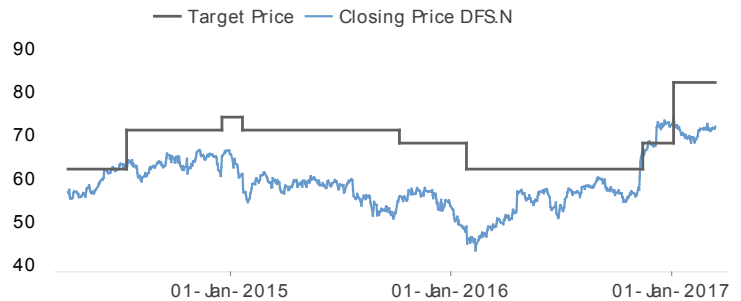
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3-Year Price and Rating History for Discover Financial Services (DFS.N)

DFS.N	Closing Price	Target Price	
Date	(US\$)	(US\$)	Rating
07-Apr-14	56.70	62.00	O
13-Jul-14	62.56	71.00	
18-Dec-14	65.01	74.00	
21-Jan-15	60.84	71.00	
08-Oct-15	55.72	68.00	
27-Jan-16	48.72	62.00	
14-Nov-16	66.70	68.00	
04-Jan-17	73.94	82.00	



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Target Price and Rating

Valuation Methodology and Risks: (12 months) for Discover Financial Services (DFS.N)

Method: Our Outperform rating and our \$82 target price for Discover Financial Services represent a PE multiple of ~12.1x our 2018E EPS and a 2018 relative PE to the S&P of 69% with Discover's long-term relative PE average of 78%. We believe that Discover will begin to build reserves as its card balances grow, providing some headwinds to the earnings growth that had been fueled by reserve releases. Discover's forward PE has ranged from 8x to 12x since 2013.

Risk: The key risks to our Outperform rating and \$82 target price for DFS are the execution into other consumer lending products, the competitive nature of the major card networks, Discover's smaller size, and lower penetration among merchants and cardmembers. The lower merchant discount rate mitigates risks related to industry pricing pressures.

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